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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 671

RAIL CAPACITY AND INFRASTRUCTURE REQUIREMENTS

COMMENTS OF UNION PACIFIC RAILROAD COMPANY

PRESENTED BY

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Date of Submission: April 4, 2007
Date of Public Hearing: April 11, 2007

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COMMENTS OF UNION PACIFIC RAILROAD COMPANY

My name is Jim Young. I am Chairman, President, and Chief Executive Officer of Union Pacific Railroad Company and its parent, Union Pacific Corporation. I am pleased to submit comments in response to the Surface Transportation Board's request for views related to rail capacity and infrastructure requirements. By focusing on transportation infrastructure, this proceeding considers what may be the most critical transportation issue facing the nation's economic future and global competitiveness, and I commend the Board for taking this initiative.

I. Overview

Our country's transportation infrastructure has been stressed: railroads, truckers, airlines, shippers, and, ultimately, consumers have been affected. All of us in the transportation sector face steadily increasing demand for transportation chasing limited transportation supply. Although the cargo growth rate has slowed temporarily in 2007, long-term growth projections tell us that the imbalance will continue well into the future. In fact, all indications are that the stress on our transportation network will intensify to the detriment of the U.S. economy. The nation is not investing enough in transportation capacity to keep pace with demand.

With this backdrop, the Board raises three basic questions. First, how much rail growth is projected? Second, are existing and planned capacity and infrastructure investments adequate

to accommodate this growth? Third, what should be done to better ensure that transportation needs are satisfied?

In my comments, I will provide UP's perspective on demand, the challenges associated with trying to address it, and the adequacy of infrastructure investment to meet the need for rail transportation. I will also discuss how UP approaches infrastructure investment and its plans for additional investment.

UP has been committed and will continue to be committed to investing in its infrastructure, as long as we foresee adequate returns on our investments. In 2007, we plan to invest a record \$3.2 billion of capital in the railroad, more than any other railroad and the most in our history. Our investments will include rebuilding existing infrastructure, adding new capacity, and supporting initiatives to enhance operating efficiencies.

At the same time, we face limits on how much capital we can invest due to our financial return requirements, the risks associated with investments, practical operating constraints, and environmental concerns, among other factors. We must invest capital prudently, balancing many interests. We can invest where we foresee the ability to achieve consistently adequate returns that will most reliably meet or exceed our cost of capital. Even when an investment would make financial sense, though, local community opposition and environmental costs sometimes keep a needed infrastructure project on the drawing board.

II. Transportation Demand Is Likely to Exceed the Capacity of Transportation Infrastructure

The Board's first question is how we foresee growth of rail traffic. We expect growth in some commodities to correspond to growth in the overall economy, or to slightly exceed those levels. We benefit from serving parts of the country where population growth rates are somewhat higher than average, giving us the possibility of additional traffic growth. In addition,

we serve West Coast ports, where import growth rates considerably exceed the overall level of economic activity. We project coal traffic to grow at higher rates than the economy, as western coal enters new markets. Ethanol business continues to expand rapidly. And worsening highway congestion increases demand for domestic intermodal service.

Our longer range projections generally correspond to those of public sources. The U.S. Department of Transportation (DOT) projects that the total demand for freight rail service (measured in tons) will increase 55 percent (1.3 billion tons) by 2020 from 1998 levels, equal to 2.0 percent per year. DOT projects a 69 percent increase (10.6 billion tons) in total freight transportation demand.¹

In a 2006 forecast, economic consultant Global Insight predicted that rail carload and intermodal tonnage will increase by 32 percent (716 million tons) from 2005 to 2017, or 2.3 percent per year. Global Insight expects total freight transportation demand to rise 30 percent by 2017.² So, there will be more demand for transportation and more demand for rail.

Government investment in transportation infrastructure is falling well short of the levels necessary to satisfy this demand. As a new AASHTO report warns, "Our generation inherited the world's best transportation system made possible by the commitment of the past two generations to invest in the country's future. We have spent that inheritance."³ That means that highway congestion will get worse, delays will lengthen for truckers and motorists, demand for

¹ U.S. Department of Transportation-*Freight Analysis Framework*, October 2002. An updated national forecast associated with a revised Freight Analysis Framework ("FIFE") is not available as of this writing.

² *U.S. Freight Transportation Forecast to 2017*, produced for the American Trucking Associations.

³ American Association of State Highway and Transportation Officials, *Transportation: Invest in Our Future*, Feb. 2007, p. 24.

rail transport will rise, and overall logistics costs will increase, adversely affecting the U.S. economy and our ability to compete globally.

Comparatively, the private rail industry may be investing more aggressively than the government is investing in highways, but still not enough to keep pace with demand. In the first of two reports on freight rail capacity needs, AASHTO estimated in 2003 that railroads will need to carry 888 million additional tons of freight annually by 2020 just to maintain their current market share of cargo transportation. AASHTO also found that railroads will need \$175 billion to \$195 billion of infrastructure investment over this period to accommodate this traffic growth, and projected that railroads will be able to fund the majority of this investment—\$142 billion—from their own sources and borrowing. Unfortunately, according to the AASHTO analysis, the \$142 billion will be enough to enable railroads to handle only half of the expected increase in rail traffic and allows no new absorption of truck traffic.⁴ So, to answer the Board's second question, under current public policies, capacity investments are unlikely to accommodate projected growth in demand, both on the highways and on the railroads.

The growing shortfall in transportation investment is a matter of great concern, not only to transportation planners but also to transportation users. I spend much of my time meeting with our customers. They deliver a consistent message. They want reliable service; they want value for what they pay; and, above all, they want Union Pacific to be there for them in the future. Our customers want Union Pacific to invest for growth. So do we.

⁴ American Association of State Highway and Transportation Officials, *Freight-Rail Bottom Line Report 50-51* (2003), <http://freight.transportation.org/doc/FreightRailReport.pdf>.

III. Union Pacific Is Committed to Investing in Its Infrastructure and New Capacity

We are doing our best to grow rail capacity. Before we start spending money for "iron in the ground" for new railroad track—we do all we can to use our existing infrastructure more efficiently. We are making great strides. We also must invest some \$2 billion annually just to keep our existing infrastructure in shape for safe and reliable service. Once we have done all we can to improve operational efficiency and have maintained our existing infrastructure, we can explore opportunities to expand capacity. Union Pacific is investing at record levels.

A. Union Pacific's Investments

Union Pacific has been investing heavily in new capacity. Our investments rose substantially in recent years and are at unprecedented levels today. In our coal network alone, Union Pacific invested over \$1.1 billion in new capacity between 1996 and 2006. This does not count the \$5 billion we spent on maintenance to carry coal or the billion dollars we invested in locomotives to transport coal over the same period. Our capacity investments included joint investments with BNSF in the Joint Line that both railroads own in the Southern Powder River Basin of Wyoming, the largest source of America's low-sulphur coal. We also added hundreds of miles of track and terminal and staging facilities in North Platte, Kansas City, South Morrill, and numerous other locations.

This investment continues. In 2007, we expect to spend almost a billion dollars on the coal network, including over \$175 million in new capacity. This investment includes adding 60 miles of third and fourth main track to the Joint Line, new tracks at our yard on the Joint Line, and third main track on Union Pacific leading to the Joint Line.

On the western half of our Sunset Route, which connects the Los Angeles Basin with El Paso, we have steadily added second main track. Today approximately 50 percent of the segment is double-tracked. Last year, we decided to accelerate that project so that—assuming

returns on investment are sufficient—the entire segment will be double-tracked by about 2010. When complete, this project will essentially double our capacity on this key route, which carries imports to and from the L.A. Basin ports and large volumes of domestic intermodal shipments. In addition, it moves grain, ethanol, autos, and lumber into the rapidly growing Southwest. Adding track on this segment also allows us to reroute some intermodal trains from our Central Corridor route to the Sunset Route, so that more capacity is available in Wyoming, Nebraska, and Iowa for other traffic. Our Sunset Route improvements extend east of El Paso as well. We have added and lengthened sidings and installed many miles of Centralized Traffic Control on our former Texas & Pacific line between El Paso and Ft. Worth, allowing us to run more trains at higher speeds. In 2007, we expect to add about 60 miles of second main track on the Sunset Route, and we plan grading for yet additional second track.

Our investments have not been limited to coal lines and the Sunset Route, however. Throughout the Midwest, the corn business is turning into an energy business, sprouting dozens of new ethanol plants. Union Pacific has spent tens of millions of dollars to build new support facilities to handle ethanol demand, both at origin points and at unloading locations. We plan to spend more than \$25 million on ethanol support facilities in 2007.

We also are investing in new track capacity in the Houston areas to smooth operations in that complex terminal. Merely as an example, we are adding additional trackage to Houston's "East Belt" line, which will reduce delays on one of the busiest segments of railroad in the region. We are building additional track and connections northwest of downtown Houston, where several of our lines intersect, to reduce delays. We also are adding capacity to our Sunset Route west of Houston toward San Antonio. And we are upgrading our Brownsville Subdivision, which runs south from Houston toward Mexico, including rebuilding connections

and yard tracks in places like Gregory, Texas, that will make switching more efficient for chemical customers.

Other examples include new capacity for soda ash loading in the Green River, Wyoming, area. We are adding trackage and passing tracks for our aggregates customers, expanding transloading facilities for steel and lumber shippers, and building lead tracks to serve customer facilities in various locations.

In addition to these track and capacity projects, we continue to invest in major commercial facilities, such as a new intermodal facility near San Antonio and another in the Houston area. We continue to expand our Marion, Arkansas, intermodal ramp west of Memphis. We are adding additional millions of dollars worth of support trackage in the Los Angeles port area, which supports operations at both L.A. Basin ports. We are beginning work on a new yard at Strauss, New Mexico, west of El Paso, which will act as a hub for container traffic to and from the California ports. These new investments come on top of a major new intermodal yard in Salt Lake City and the huge Dallas Intermodal Terminal southeast of Dallas. As the Board can see, we are putting steel into the ground.

We also have been steadily rebuilding the large freight yards that handle our carload business, including chemicals. For many years, carload traffic stagnated, and we gave lower priority to upgrading our carload switching yards. At Union Pacific, we have refocused on our yards and are systematically reconstructing them to allow them to operate more efficiently and handle more traffic. By combining these investments with rigorous process-management programs, we are seeing dramatic results, with a steady decline in car dwell (the amount of time cars spend in our yards).

B. Union Pacific's Investment Requirements

Although Union Pacific is investing at record levels and hopes to maintain that pace for the next few years, our capacity needs are substantial and grow as our customers' needs grow. Here are a few examples:- Our Central Corridor from Salt Lake City and Ogden to Chicago is double-tracked, and on some segments we have triple and even quadruple track on this line, the busiest freight line in the world. We have installed Centralized Traffic Control ("CTC") over large segments of this line in Iowa and Illinois, and we continue to expand CTC, but we need more, including across eastern Nebraska and then across large parts of Wyoming. We also need to add segments of third main track, so faster trains can pass slower trains. In a few years, we will need to expand our triple track east of North Platte into quadruple main track. The St. Louis terminal is becoming a choke point as coal traffic grows, and Chicago needs billions of dollars of capacity. The CREATE initiative is underway this year to reduce the frequent delays in that terminal.

If ethanol expansion continues, as seems likely, we will need to add even more capacity to our gathering network in Iowa, in addition to building more support facilities at loading and unloading points. International traffic continues to grow through our Eastport, Idaho, gateway with Canadian Pacific, calling for more capacity on our line through Spokane. As we continue to expand the Sunset Route west of El Paso, we will need to add capacity east of El Paso on the network of mainlines that fan across Texas toward San Antonio, Houston, Dallas, and Kansas City. Growing rock and sand traffic in Texas will require additional capacity. Our gateways to Mexico will need more investment.

In a major challenge, our former Rio Grande route between Denver and Bond, Colorado, is nearing capacity. If traffic grows, we will need to find a solution to the challenge of the

Moffat Tunnel, more than six miles long, where capacity is limited by the time required to remove diesel exhaust from the tunnel. In the Pacific Northwest, we operate over BNSF's line between Portland and Tacoma. This line needs more capacity to handle freight for both railroads, as well as several Amtrak trains. Union Pacific's line north of Tacoma also needs additional capacity. These are just some of the capacity challenges and choke points we face.

Another challenge that, in my opinion, has not yet received enough attention is the need to rebuild major rail infrastructure nearing the end of its useful life. Every railroad has examples. We may have a few more than others, because the railroads we acquired over the years, particularly Chicago & North Western, Missouri-Kansas-Texas, and Southern Pacific, had deferred maintenance and needed extensive rebuilding. Examples on our railroad include the aging Mississippi River bridge at Clinton, Iowa, which will need to be replaced in coming years at a cost of well over \$100 million. The high Union Pacific bridge over the Mississippi at Memphis—a key gateway between UP and eastern connections—will eventually need to be rebuilt, as will the bridge outside my window across the Missouri River between Council Bluffs and Omaha. We inherited hundreds of miles of bridges constructed of wood, and many of those must be replaced (we have accelerated our investments to do that). Note that these replacement costs will be much higher than the historic costs often used by policymakers.

C. Union Pacific Investments in Carload Traffic

As the nation's leading carrier of "manifest"—individual carload—shipments, Union Pacific has a unique perspective on these shipments that do not move in unit trains. Some have suggested that railroads are attempting to exit this business. We are not. At Union Pacific, we view our manifest network as a franchise strength, which is why we carry more carloads of manifest traffic annually than any major U.S. railroads. We recognize that our manifest service

is often the link between smaller communities and the global economy. It also reduces traffic on highways, providing a safer and environmentally superior alternative to truck shipments.

Manifest traffic is resource-intensive and uses investments less efficiently than other types of traffic. In order to handle manifest traffic, Union Pacific owns and maintains more than 20 large classification yards, from Livonia (near Baton Rouge) to West Colton (Southern California) to Hinkle (eastern Oregon) to Proviso (Chicago). At each of these yards, we own large tracts of valuable real estate and maintain miles of expensive track and switches. We employ thousands of employees to disassemble inbound trains and sort the cars into outbound movements. Although shippers provide some of the cars, Union Pacific owns tens of thousands of cars for manifest traffic and employs thousands of road and switching locomotives to handle the business.

All of our assets must earn a return on investment, but this is a special challenge with manifest traffic. We maintain a higher level of investment in assets to support manifest shipments than we do for unit trains carrying coal, autos, containers, or grain. Even with substantial improvements in our yard efficiency and significant gains in over-the-road performance, utilization of freight cars is comparatively poor. Many cars make only one "turn" from origin to destination and back in 30 to 40 days, while a unit coal train can complete a cycle in five to seven days and intermodal containers can make two round trips per month between Los Angeles and Memphis. When demand slows, as it has recently in the lumber business, these expensive assets sit in storage, generating no revenue and consuming track capacity. We are working with our customers, as well as on our own property, to find ways to reduce this car-cycle time and improve use of assets.

Returns on investment must be sufficient to justify maintaining these assets and adding new ones. Like any rational business in the U.S. economy, we must devote our scarce investment dollars to traffic that brings the highest return on investment. That ensures that capital will be used more efficiently than any central planner could dictate.

This can create a political problem, because some of the smallest shippers who ship the fewest cars may be the least efficient to serve and the least efficient in their own operations. We need to be able to make a reasonable return on the investments we devote to their business, or other customers will unfairly subsidize them. The nation's economy rewards efficiency and innovation; neither the economy nor government policy subsidizes businesses that do not compete effectively. We want to continue to serve manifest customers, and we will continue to do our part, but—at the same time—these customers need to maximize their efficiency on the rail network, and their rates must provide an adequate return on our enormous investment in their type of business.

As rail capacity has become increasingly stressed in recent years, a problem has emerged that railroads had not been forced to confront in living memory. We have been asked to provide new service to customers who wanted to locate along main lines that were operating at or near capacity. Of course, we always want to say "yes," because new business means new revenues. We discovered, however, that we had to place limitations on our "yes" enthusiasm. Serving a customer from one of our mainlines consumes a large amount of capacity, just as a stoplight for a local storeowner would slow traffic on an interstate highway. A train must stop on the mainline, blocking it and preventing other trains from operating. This local service can easily take an hour or even many more, especially if the trackside customer needs several cars placed in specific places in its facility. During that time, we cannot operate through trains on that track. As a

result, a track that could handle 45 trains a day may be restricted to 40 so we can deliver a few cars to a manifest shipper. Meanwhile, hundreds, possibly thousands, of other shipments are delayed, and service quality declines for all of those other shippers.

To address this situation in a capacity-constrained environment, we had to establish guidelines for how we serve new traffic, and we also are working with existing manifest customers to find less disruptive ways of meeting their needs. One example is for a new shipper to construct a side track where the local train that serves its facility can get off the mainline and out of the way of other traffic, like an off ramp on an interstate. To fund this capacity, someone—either the railroad or the shipper—must see an adequate return on investment in the added capacity. Forcing a railroad to add capacity with inadequate returns would be counter-productive. It would require us to reduce higher-utility investments elsewhere and reduce the total amount we can invest and the total volume of traffic we can carry in the future.

Union Pacific wants to continue to support manifest traffic and to provide value to our manifest customers. To do that, we must ensure that the traffic justifies replacing assets and continuing investment. Public policy needs to support these goals. Federal rate regulation needs to reflect the full costs of serving these and other shippers. In particular, it must reflect the much higher costs of replacing track, replacing locomotives, and replacing other equipment, rather than historic values. We will have little incentive to invest in expensive assets if regulation limits us to recovery based on outdated investment values.

IV. Union Pacific Faces Constraints on Investments

Many factors influence how much and where we make infrastructure and capacity investments. Even though the rail industry invested some \$360 billion in capital and maintenance expenses related to infrastructure and equipment between 1980 and 2005—a higher percentage of revenue than any other industry—and will spend another \$8 billion in 2006, rail

infrastructure investment, according to AASHTO, will not be adequate for future growth. AASHTO has voiced concerns, concluding that if rail investment levels are not increased significantly, the freight rail network will experience an investment shortfall of \$53 billion by 2020 in handling growth of its existing traffic; *i.e.*, to retain current market share as demand grows. This figure does not take into account what will be needed to handle projected new demand for rail service or to relieve highway congestion.⁵

As I have indicated, and UP's record of investment reinforces, UP is committed to infrastructure investments to the extent that we are able. But, if we are to have any hope of bringing supply closer to demand, we must make sure that UP and the other railroads earn sufficient revenues to sustain an increased level of investment. We need a regulatory and local community environment that will justify continued investment and infrastructure enhancements.

A. Union Pacific Can Invest Only When Returns on Investment Are Sufficient

For decades, Union Pacific, like the rest of the railroad industry, failed to earn its cost of capital. Although we are getting closer to that target, Union Pacific has not yet reached it. Our earnings continue to fall short of the level necessary to recreate our rail system, especially at today's costs. In order to justify new investment in capacity, we must have a high degree of confidence that we will recover that investment plus a reasonable return. In a capacity-constrained environment, returns on historical investment values are meaningless. We need to be confident that we can cover the forward-looking costs of making the investment and maintaining it. Investment in rail lines is expensive, and it commits us for long periods of time.

⁵ 2003 *Freight-Rail Bottom Line Report*, *supra* note 9, at 4.

This requirement of adequate revenues has several implications. First, adequate returns on investment must be sustained over time. A few years of adequate revenues will not justify continuing investment in capacity. When we reach revenue adequacy, as we expect to, we cannot declare victory. We need to sustain that performance, or we will be forced to reduce investment.

Second, we need to have reasonable assurance that our investments will continue to generate adequate revenues for an extended number of years. All investments carry risk, of course. As a railroad investing in long-lived assets, however, we cannot risk investing in a business that has a substantial likelihood of disappearing in a few years. For example, the coal business looks like one of our most promising, long-term lines of business, and we are investing on that assumption. A sudden shift to nuclear power, however, could sharply reduce demand for coal. We are watching closely debates in Washington about greenhouse emissions to assess whether projected coal growth will be curtailed. Similar questions arise in connection with ethanol investments, which depend heavily on congressional willingness to subsidize the product. Other types of cellulose are being explored to determine whether they are more efficient sources of alternative fuel than corn.

Third, we must ensure that our financial offerings qualify as investment-grade. As our financial performance has improved in recent years, we have strengthened our credit metrics and increased the amount of debt that our cash flow can support. This will benefit our customers by providing a cost-effective source of funding for continued, and possibly greater, investment in the years ahead. But our debt capacity is far from unlimited. Most of the railroad industry remains only one full level above junk-bond status.

Our customers, our employees, and our long-term shareholders depend on us to be a strong, financially healthy company for a long time to come. To ensure this, we believe it is critical to have a solid investment-grade rating. This enables us to maintain a reasonable cost of capital, while retaining the flexibility to withstand market uncertainties and other unforeseen events over the long term. (At a recent conference in Jacksonville, all of the Chief Financial Officers of the major railroads independently agreed on this principle.) If we fail to do that, our borrowing costs will increase, and our ability to access capital markets in difficult economic times will be restricted, restraining our ability to invest. Many large investors, particularly government pension funds, would be forced to divest our securities should they decline to junk-bond status.

Some of our shareholders already question whether Union Pacific is investing too much in infrastructure. A few might prefer that we run the business for short-term profit, while constraining capacity. Fortunately, the majority of our shareholders believe in our vision of the future: one in which we can continue to invest in new opportunities that will generate better returns on investment and ultimately provide greater returns to our stockholders. If we push the investment envelope much further, though, we could lose the confidence of those long-term shareholders. The industry needs their commitment, because some short-term investors want companies to take imprudent risks in order to pull cash out of the business.

Fourth, government policies must provide the consistent framework that we need in order to avoid unreasonable risk. For example, government policy that drives all rail rates down to a revenue-to-variable-cost ratio of 1.8 would cost the industry billions of dollars and would bring substantial investment in new capacity to a halt at Union Pacific. Similarly, government policy

that allows any customer to choose interchange points would squander past investments and create new investment needs that we could not satisfy.

B. Rail Infrastructure and Service Quality

We thoroughly understand that we must provide reliable quality service in order to justify prices that will allow us to earn an adequate return on investment. Our customers are willing to pay for value, but they are not willing over the long term to pay higher prices for poorer service. Accordingly, good service is a key to our ability to invest capital. Union Pacific's service quality has improved significantly over the last year, as our customer surveys and comments confirm.

This paradigm creates multiple linkages between service quality and capacity. At the most basic level, we cannot provide good service if our network is congested and trains cannot move. We need sufficient resources (crews, locomotives, and track capacity) to provide the service our customers expect. We, therefore, need to maintain a balance between the traffic we accept and the capacity we own. We maintain this balance as any other business would in the marketplace: we adjust prices to reflect demand in the market, at least where contracts give us that freedom. If we fail to act in this responsible manner, we could again be overwhelmed by more traffic than we could handle and suffer severe congestion, a situation we encountered in the fall of 2003 when traffic surged unexpectedly.

Requiring us to satisfy all demand and requiring us to provide reliable service on infrastructure that lacks capacity to meet every shipping demand would put us in an impossible position. Coupling such a requirement with government-controlled freight rates, so that we have even less to invest in capacity, would create an irrational situation in which public policy would

make no sense, would decrease investment, and would impose a transportation tax on the nation's motorists, consumers, and the economy as a whole in the form of severe congestion.

Some suggest that the solution to the rail capacity challenge is to revise federal law so that railroads are required to provide reliable and efficient service or pay damages for delays. This would be exactly like making it unlawful for trucks to be delayed by congestion on interstate highways or in urban areas. It is unfair and makes no sense. Motor carriers cannot provide better service than the government's limited investments in highways will permit them to provide, and fining them for getting stuck in traffic will accomplish nothing except to increase the cost of transportation and force truckers out of business. The same is true of railroads.

Finally, we cannot invest for the future unless we provide service that justifies what we call reinvestible rates--rates that are sufficient to allow us to replace the infrastructure that we use to provide the service. We still suffer under the impact of several older transportation contracts that are well below reinvestible levels, and those contracts act as a drag on our ability to invest for the future. As they expire and are replaced by market-based rates, we will be better positioned for investment. If government acts in a manner that allows us to obtain market-based, reinvestible rates, our ability to invest in capacity will grow, and the amount of traffic we can carry will expand. It's that simple.

C. Community Concerns and Opposition

My comments to this point have focused on financial constraints associated with infrastructure investment. But even where an investment makes sense from a financial perspective, it may nevertheless be blocked by community opposition. More and more communities are objecting to any initiative that will result in increased train traffic—the "Not In My Backyard" phenomenon. This is especially likely where communities see no personal

benefits from rail enhancements. I could cite many examples, but I will focus on a few recent experiences that are illustrative.

The first was a capacity project that we pursued jointly with BNSF to exchange existing lines in southeastern Missouri. The project would have permitted the railroads to use directional running, enhancing the efficiency of movements flowing through the area without spending tens of millions of dollars to expand capacity on other routes. This would have resulted, however, in more train traffic through the modest-sized town of Sikeston. In view of aggressive community opposition—notwithstanding significant offers of mitigation—and threats of lawsuits, Union Pacific concluded that the costs of dealing with the community, as well as the delays, could exceed the costs of building other facilities. We abandoned the project, increasing overall capacity costs.

The second example deals with legislation currently pending in the Arizona legislature that would severely restrict railroad use of state eminent domain authority. As the Board knows, railroads use state eminent domain authority sparingly to acquire land necessary for rail expansion projects. Usually, we can negotiate a fair price because that legal authority exists. By reducing or eliminating this authority, the Arizona legislation may limit our ability to expand our Sunset Route. To make use of new rail capacity, we need a strategically located carload freight yard that we hope to construct near Red Rock, Arizona, a point on the desert northwest of Tucson. This location is ideal, on flat land pivotally near the junction of our Sunset Route and our line to Phoenix. Mounting local opposition threatens this facility, even though it would employ hundreds of people and generate substantial commercial and economic development for the State of Arizona. The Arizona legislation could make the project cost-prohibitive.

Finally, both BNSF and UP confront extensive local opposition to building or expanding intermodal facilities near the Ports of Los Angeles and Long Beach. Those facilities will soon be essential to handle ever-growing imports through the ports. Combined, the ports are the nation's busiest, and traffic projections show huge, continuing growth for decades to come. Even after maximizing use of "on-dock" loading, though, we will need more capacity to load containers on rail cars near these ports, and both railroads have proposed the greenest possible facilities (a new one in BNSF's case, a reconstructed facility in UP's). UP proposes a \$300 million rebuilding of our Intermodal Container Transfer Facility, which will double its capacity while substantially reducing emissions. The environmental alternatives to these projects are far worse, forcing thousands of trucks onto already congested highways and increasing air pollution. Nevertheless, local opposition to these projects, if successful, could force containers to other ports, possibly in other nations, or substantially increase the cost of imported goods, while increasing pollution.

Commuter rail service presents another potential constraint on cargo-capacity investment. Although the residents of urban and suburban areas often do not want more freight trains, they often want more passenger trains. They see our rail lines as prime routes to launch additional rail passenger service. In many instances, railroads and commuter agencies can reach win-win accommodations. In others, though, commuter rail demands could impose such severe constraints on freight transport that they would have national implications. In several situations, for example, encroaching urban development, environmentally sensitive areas, or geology leave no room for future expansion. The nation's freight railroads cannot afford to commit new track capacity to passenger service where additional freight capacity cannot then be added. Commuter interests also need to recognize that the increments of capacity needed to add the next group of passenger trains will make additional capacity for freight even more expensive.

The regulatory and public policy environment, at both the local and federal levels, must be conducive to freight infrastructure investment. Railroads do not want to be insensitive or ignore community concerns, and investment costs already are rising as we attempt to be good neighbors and provide mitigation. The entire nation, however, needs freight railroads to expand. Without a supportive regulatory environment, investments will be reduced, and capacity constraints and congestion will worsen.

V. Options for Addressing the Rail Capacity Challenge

The third question the Board asks is what should be done to better ensure that infrastructure investments are adequate. Union Pacific expects to invest as much capital in infrastructure as it prudently can, considering the rates of return on particular investments, our ability to spend efficiently, and the other considerations we must weigh. The better we perform financially, the more we could invest. Nevertheless, AASHTO and others predict that railroads will not be able to invest enough to address projected growth.

The investment tax credit (ITC) and public private partnerships (PPPs) can play important roles. The ITC provides an additional financial incentive that allows us to accelerate investments that we could not otherwise support. In considering the ITC, we encourage policymakers to keep in mind that our competitors --all of them-- are heavily subsidized. Truck user fees do not come close to paying the full cost of their impact on roadways. Barges use a heavily subsidized lock-and-dam system needing replacement. Air cargo services operate from airports supported by the public, through air space controlled by the federal government at taxpayer costs. Meanwhile, railroads must build their own steel highways, and then must pay property taxes on top of it. They also fund uniquely expensive benefit and legal regimes under federal law. An ITC would merely be a step in leveling the playing field.

PPPs, properly framed, can also address capacity needs. Many projects that cannot be justified from a private investment perspective are worthwhile because of their public benefits. In these circumstances, public investment funds should complement railroad investment funds. It is important to emphasize, however, that PPPs should not be used to extract private investments that could not otherwise be justified by a private enterprise: railroad investment dollars should be used for railroad benefits; public investment dollars should fund public benefits. Otherwise, rail investment dollars would be drawn away from other projects for which investment would be better justified, thereby hindering railroad efforts to address the need for more transportation capacity.

California appears to be taking a major initiative toward PPPs. Already we have worked with the State and public agencies to expand rail capacity in Southern California and in the Oakland-Roseville-Stockton-San Jose area, all to support commuter operations. More recently, voters approved a major transportation funding initiative. Among the projects high on the list are an essential, \$250 million grade separation of the UP and BNSF mainlines at Colton, California, which is a persistent bottleneck. In addition, proposals are pending to increase capacity over UP's Oakland-Sacramento line to improve access to the Port of Oakland, and on UP's Central Corridor line through the Sierra Nevada Mountains and over Tehachapi Pass (used by both UP and BNSF, but mostly by BNSF). The latter projects would improve transportation to and from the Port and northern California. Projects like these bring public benefits that justify extensive public participation.

One specific type of public benefit deserves special mention. Grade-crossing separations are extremely expensive, often exceeding \$30 million and sometimes much more. Like all crossing protection, they exist to protect the motoring public and provide minimal benefit to

railroads. We cannot be the primary funding source for new crossing protection to protect motorists (including our competitors, the truckers), particularly for expensive grade separations. We are paying more than our share already. The railroad industry contributes heavily to crossing protection by maintaining crossings and equipment. Union Pacific alone spends over \$100 million annually to maintain crossing signals once constructed and to keep crossing surfaces in good shape. If railroads were charged with the full costs of all desired highway separations, we would have no money left for rail capacity.

VI. Conclusion

Often overlooked in discussions of transportation capacity is a pivotal fact: the marketplace is responding as it should. For decades, saddled by extensive regulation and government-determined rates, railroads lost the financial ability and incentive to invest. Their rates of return were so anemic that many railroads declared bankruptcy, while others shifted capital to better opportunities in other businesses. Railroads and customers who relied on them suffered through a long period of decline, with deteriorating infrastructure, declining service, and poor safety records. The rail share of intercity freight fell sharply.

Early in this new century, the marketplace signaled an historic change. Demand for transportation began to exceed supply, a trend that, with short-term variations, appears likely to continue. The market responded exactly as markets should. For the first time since the 1920s, railroads are investing heavily for the future. They are providing more transportation for more customers. Their physical plants continue to improve. Their safety records have never been better. They provide the most environmentally friendly, most fuel-efficient transportation available to most shippers. They are far more competitive than they were when government

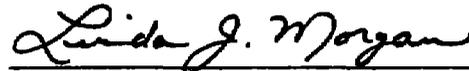
prohibited rate competition, and they engage in competitive battles against competing modes and each other every day.

The greatest challenge facing the nation's transportation system in the future is inadequate capacity for the growth coming our way. The most important actions public officials can take to address this challenge in the rail industry are to allow the marketplace to work as fully as possible and to protect and enhance the railroads' opportunities to earn revenues that will justify and stimulate investment. Railroads may not be able to invest as much as we would like, but we are making substantial progress. Improving returns on investment will stimulate even more investment in the future.

Conversely, actions that reduce railroad returns on investment will cause the marketplace to respond exactly as markets always do: it will force railroads to reduce investments in existing and new capacity. Railroad rates must provide adequate returns on the costs of investment. If railroads are to grow, as the economic needs of the country dictates, railroad rates must provide adequate returns on the costs of new investment. Unless one believes that large tax increases and public support are on the way (and Amtrak's experience suggests the reliability of that funding source), there is no other source of revenue to fund investment in private highways made of steel.

I can assure the Board that Union Pacific wants to do all it prudently can to grow for our customers, our employees, and our shareholders, and to provide the reliable service our customers need. And we want to make sure we have the financial capability to do just that.

Respectfully submitted,



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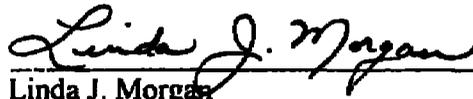
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April 4, 2007

CERTIFICATE OF SERVICE

I, Linda J. Morgan, certify that, on this 4th day of April, 2007, I caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in Ex Parte No. 671.


Linda J. Morgan